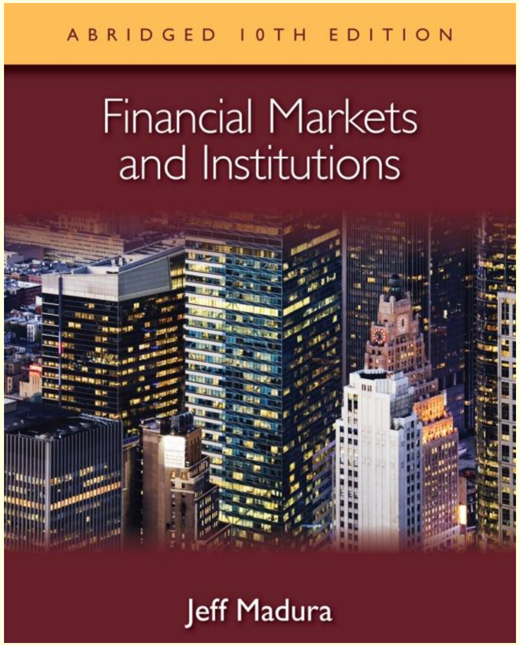
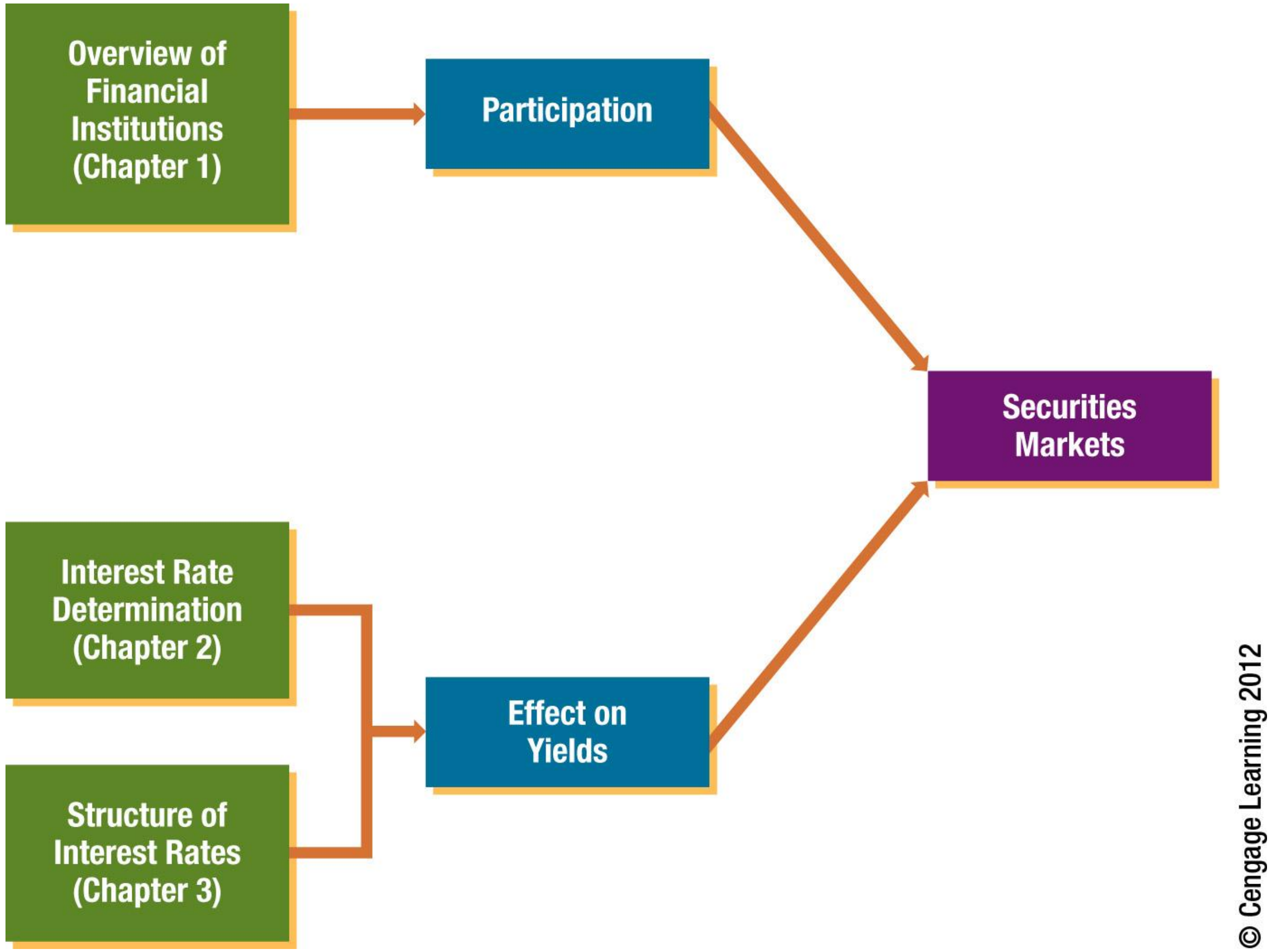
Financial Markets and Institutions
Abridged 10th Edition

by Jeff Madura



Part 1 Overview of the Financial Environment



Chapter Objectives

- describe the types of financial markets that facilitate the flow of funds
- describe the types of securities traded within financial markets
- describe the role of financial institutions within financial markets
- explain how financial institutions were exposed to the credit crisis

Financial Market

A market in which financial assets (securities) such as stocks and bonds can be purchased or sold. Funds are transferred in financial markets when one party purchases financial assets previously held by another party.

Role of Financial Markets

Financial markets transfer funds from those who have excess funds to those who need funds.

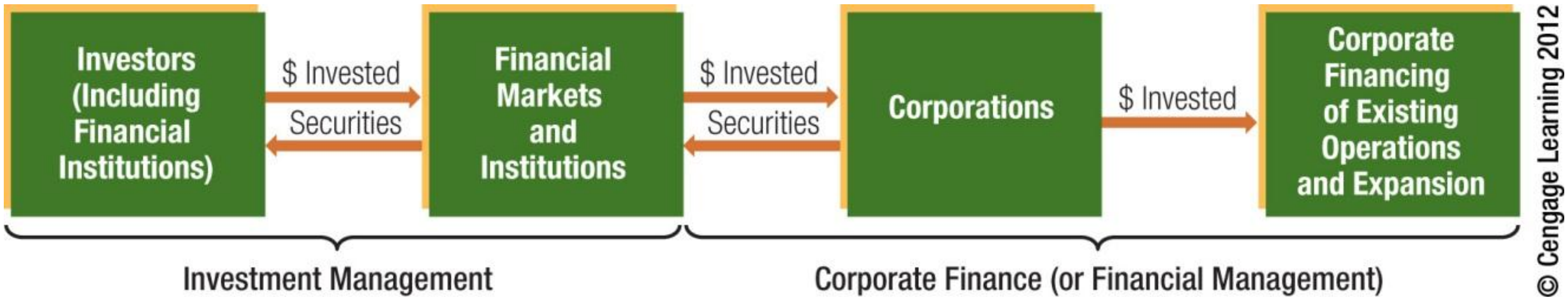
1. **Surplus units:** participants who receive more money than they spend, such as investors.
2. **Deficit units:** participants who spend more money than they receive, such as borrowers.
3. **Securities:** represent a claim on the issuers
   a. Debt securities - debt (also called credit, or borrowed funds) incurred by the issuer.
   b. Equity securities - (also called stocks) represent equity or ownership in the firm.

Role of Financial Markets

1. **Accommodating Corporate Finance Needs:** The financial markets serves as the mechanism whereby corporations (acting as deficit units) can obtain funds from investors (acting as surplus units).

2. **Accommodating Investment Needs:** Financial institutions serve as intermediaries to connect the investment management activity with the corporate finance activity.

Exhibit 1.1 Comparison of Roles Among Financial Institutions



Primary versus Secondary Markets

1. **Primary markets** - facilitate the issuance of new securities

2. **Secondary markets facilitate** - the trading of existing securities, which allows for a change in the ownership of the securities

   a. **Liquidity** is the degree to which securities can easily be liquidated (sold) without a loss of value.

   b. If a security is illiquid, investors may not be able to find a willing buyer for it in the secondary market and may have to sell the security at a large discount just to attract a buyer.

Securities Traded in Financial Markets

Securities can be classified as **money market** securities, **capital market** securities, or **derivative** securities.

1. Money Market Securities

a. Money markets facilitate the sale of short-term debt securities by deficit units to surplus units.

b. Debt securities that have a maturity of one year or less.

Securities Traded in Financial Markets (Cont.)

2. **Capital Market Securities** - facilitate the sale of long-term securities by deficit units to surplus units.

   a. **Bonds** - long-term debt securities issued by the Treasury, government agencies, and corporations to finance their operations.

   b. **Mortgages** - long-term debt obligations created to finance the purchase of real estate.

   c. **Mortgage-backed securities** - debt obligations representing claims on a package of mortgages.

   d. **Stocks** - represent partial ownership in the corporations that issued them.

Securities Traded in Financial Markets (Cont.)

3. **Derivative Securities** - financial contracts whose values are derived from the values of underlying assets

   a. **Speculation** - allow an investor to speculate on movements in the value of the underlying assets without having to purchase those assets.

   b. **Risk management and hedging** - financial institutions and other firms can use derivative securities to adjust the risk of their existing investments in securities.

Valuation of Securities

1. Impact of information on valuations
   a. Estimate future cash flows by obtaining information that may influence a stock's future cash flows. (Exhibit 1.2)
   b. Use economic or industry information to value a security
   c. Use published opinions about the firm's management to value a security.
2. Impact of internet on the valuation process
   a. More timely pricing
   b. More accurate pricing
   c. More informative pricing

Valuation of Securities

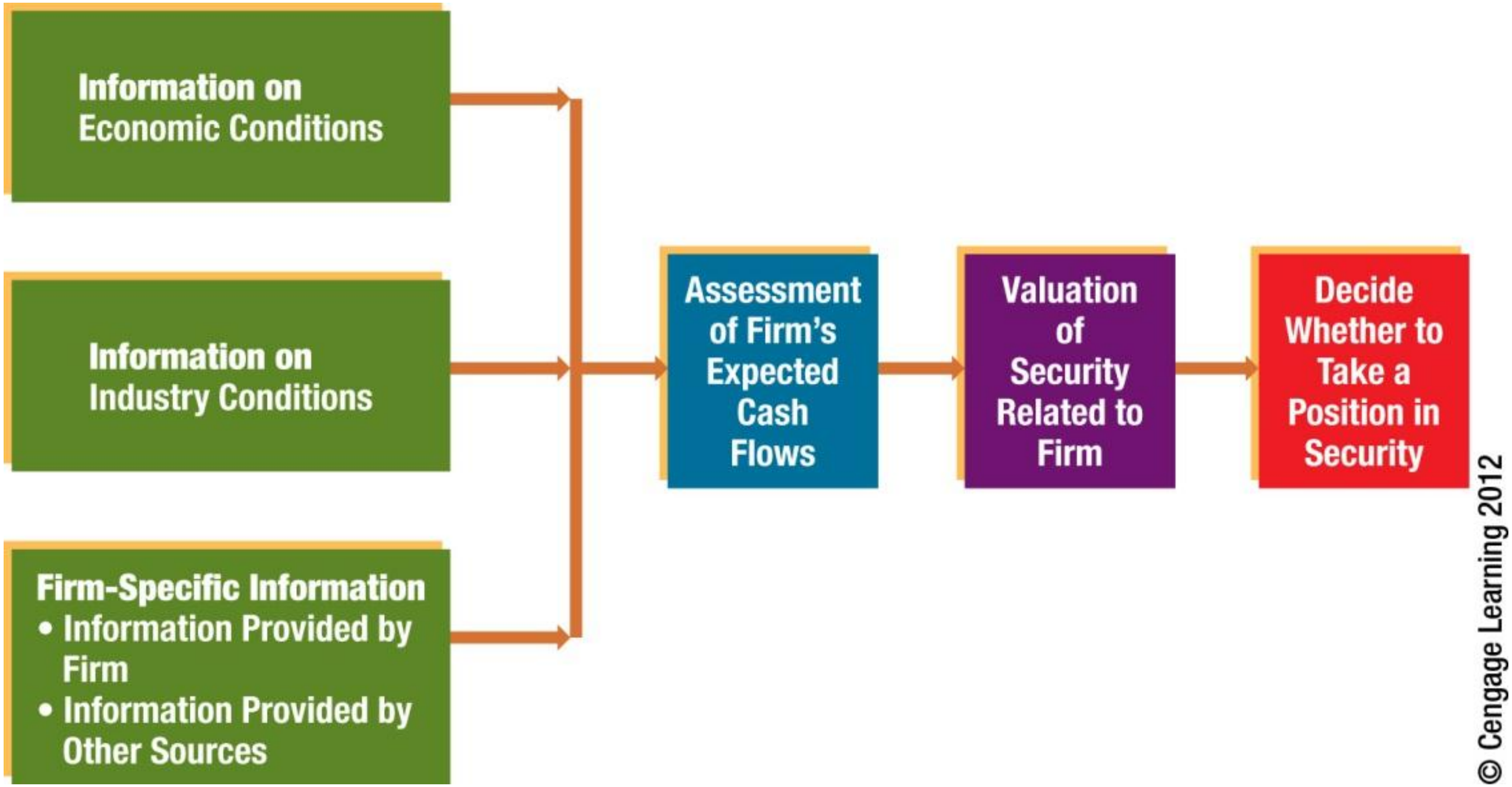
3. Impact of Behavioral Finance on Valuation

   a. Various conditions can affect investor psychology. Behavioral finance can sometimes explain the movements of a security's price.

4. Uncertainty Surrounding Valuation of Securities

   a. Limited information leads to uncertainty in the valuation of securities.

Exhibit 1.2 Use of Information to Make Investment Decisions



Securities Regulation

1. Required Disclosure

a. The **Securities Act of 1933** was intended to ensure complete disclosure of relevant financial information on publicly offered securities and to prevent fraudulent practices in selling these securities.

b. The **Securities Exchange Act of 1934** extended the disclosure requirements to secondary market issues.

2. Regulatory Response to Financial Reporting Scandals

a. The **Sarbanes-Oxley Act** required that firms provide more complete and accurate financial information.

International Securities Transactions

1. Financial markets vary across the world in terms of:
    a. Degree of financial market development
    b. Volume of funds transferred from surplus to deficit units
2. **Foreign Exchange Market** - International financial transactions normally require the exchange of currencies. The foreign exchange market facilitates this exchange.

Role of Financial Institutions

Financial institutions are needed to resolve the limitations caused by **market imperfections** such as limited information regarding the creditworthiness of borrowers.

1. **Role of depository institutions** - Depository institutions accept deposits from surplus units and provide credit to deficit units through loans and purchases of securities.
   a. Offer liquid deposit accounts to surplus units
   b. Provide loans of the size and maturity desired by deficit units
   c. Accept the risk on loans provided
   d. Have more expertise in evaluating creditworthiness
   e. Diversify their loans among numerous deficit units

Role of Financial Institutions

Depository Institutions include:

1. **Commercial Banks**
   a. The most dominant type of depository institution
   b. Transfer deposit funds to deficit units through loans or purchase of debt securities
2. **Savings Institutions**
   a. Also called thrift institutions and include Savings and Loans (S&Ls) and Savings Banks
   b. Concentrate on residential mortgage loans
3. **Credit Unions**
   a. Nonprofit organizations
   b. Restrict business to CU members with a common bond

Role of Financial Institutions

2. Role of **nondepository institutions**

   a. **Finance companies** - obtain funds by issuing securities and lend the funds to individuals and small businesses.

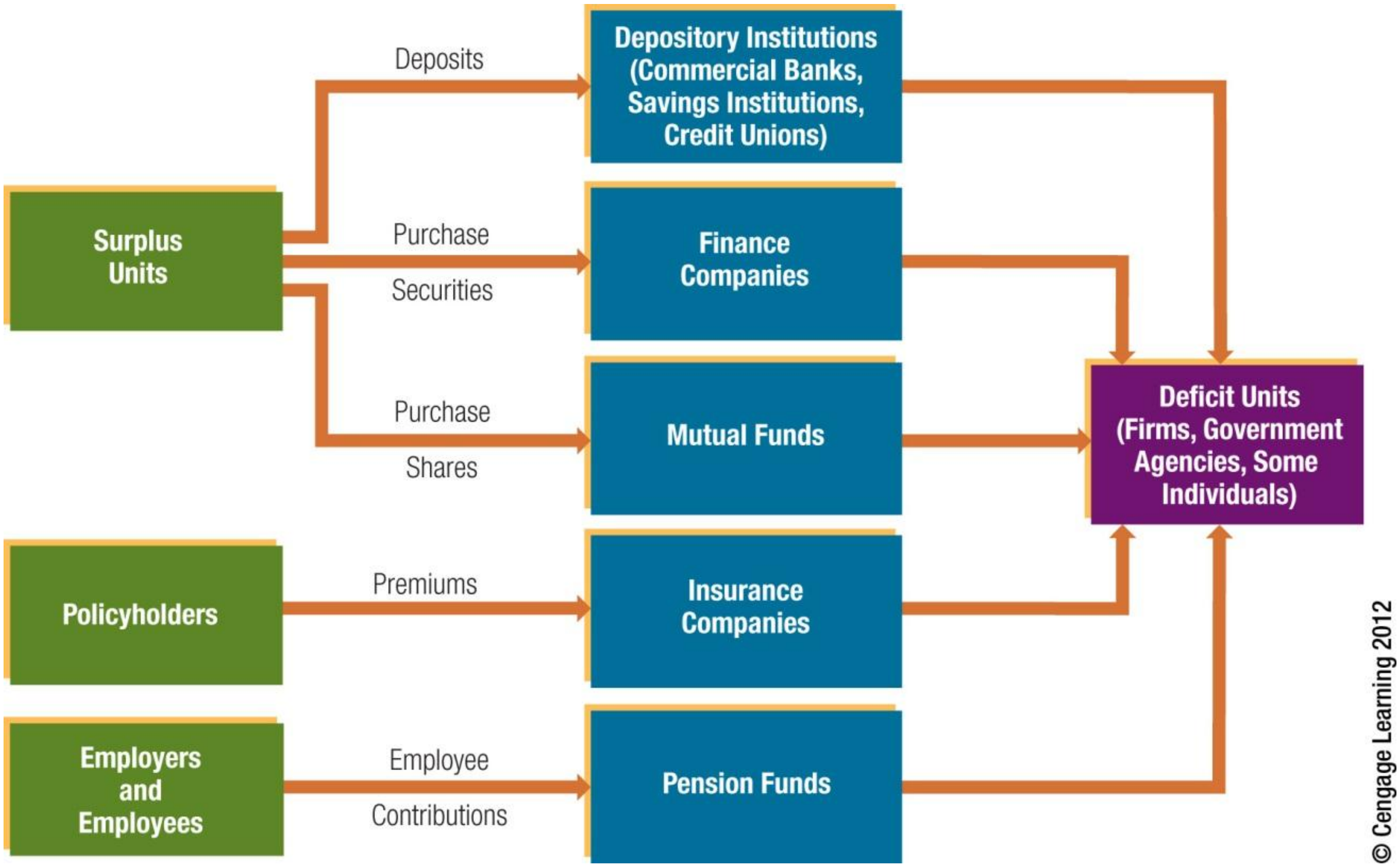
   b. **Mutual funds -** sell shares to surplus units and use the funds received to purchase a portfolio of securities.

   c. **Securities firms** - provide a wide variety of functions in financial markets. (Broker, Underwriter, Dealer, Advisory)

   d. **Insurance companies -** provide insurance policies that reduce the financial burden associated with death, illness, and damage to property. Charge premiums and invest in financial markets.

   e. **Pension funds** – manage funds until they are withdrawn for retirement

Exhibit 1.3 Comparison of Roles among Financial Institutions



Comparison of Roles among Financial Institutions

1. Financial institutions **facilitate the flow of funds** from individual surplus units (investors) to deficit units.

2. Financial institutions also serve as **monitors** of publicly traded firms.

    1. By serving as **activist shareholders**, they can help ensure that managers of publicly held corporations are making decisions that are in the best interests of the shareholders.

How the Internet Facilitates Roles of Financial Institutions

The Internet has enabled financial institutions to perform their roles more efficiently.

1. Allows for lower costs and fees.
2. Makes firm more competitive forcing other firms to price their services competitively

Relative Importance of Financial Institutions

1. Households with savings are served by depository institutions.
2. Households with deficient funds are served by depository institutions and finance companies.
3. Several agencies regulate the various types of financial institutions, and the various regulations may give some financial institutions a comparative advantage over others.

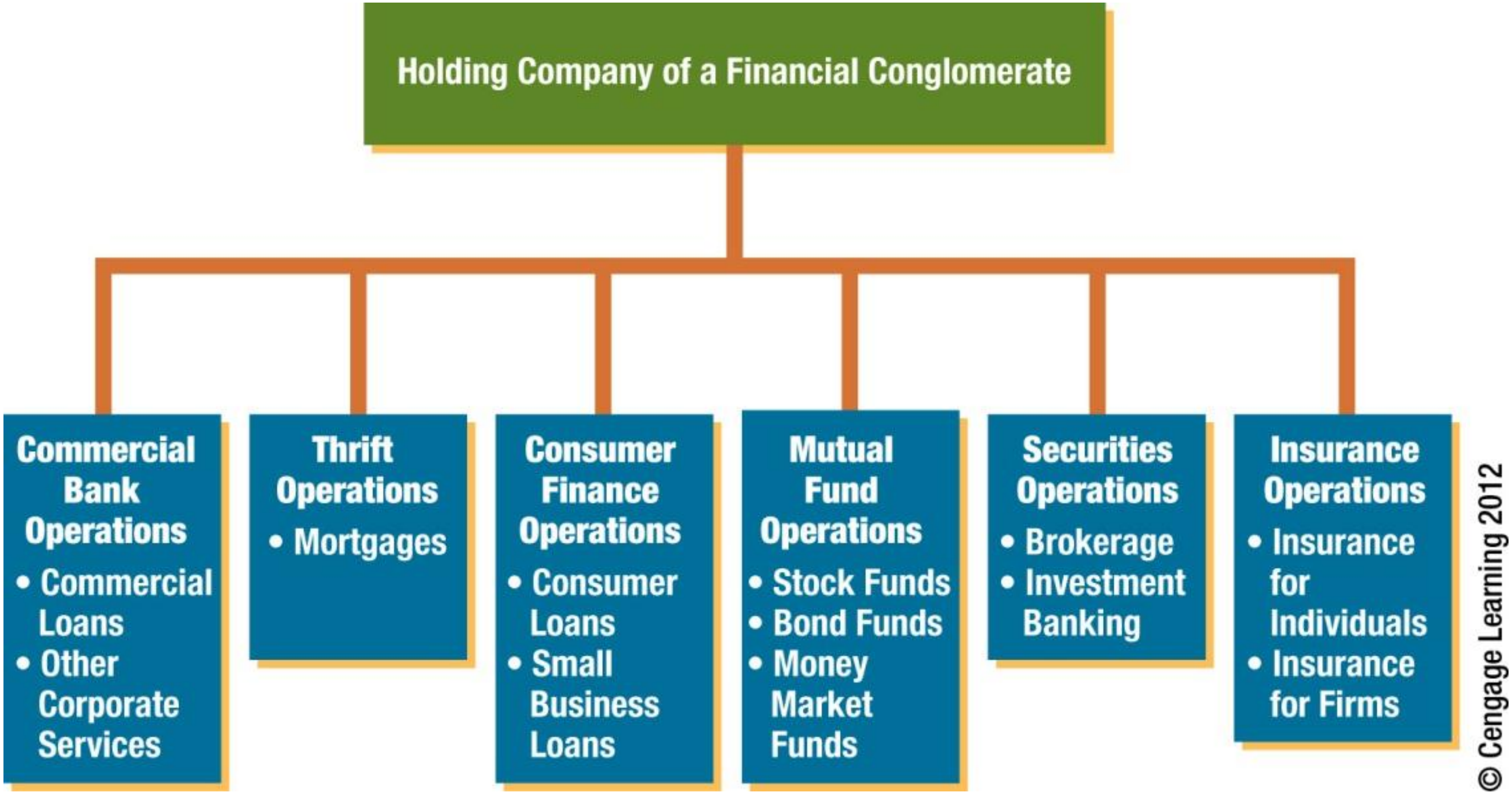
Exhibit 1.4 Summary of Institutional Sources and Uses of Funds

FINANCIAL INSTITUTIONS	MAIN SOURCES OF FUNDS	MAIN USES OF FUNDS
Commercial banks	Deposits from households, businesses, and government agencies	Purchases of government and corporate securities; loans to businesses and households
Savings institutions	Deposits from households, businesses, and government agencies	Purchases of government and corporate securities; mortgages and other loans to households; some loans to businesses
Credit unions	Deposits from credit union members	Loans to credit union members
Finance companies	Securities sold to households and businesses	Loans to households and businesses
Mutual funds	Shares sold to households, businesses, and government agencies	Purchases of long-term government and corporate securities
Money market funds	Shares sold to households, businesses, and government agencies	Purchases of short-term government and corporate securities
Insurance companies	Insurance premiums and earnings from investments	Purchases of long-term government and corporate securities
Pension funds	Employer/employee contributions	Purchases of long-term government and corporate securities

Consolidation of Financial Institutions

1. **Typical Structure of a Financial Conglomerate** - In recent years, the barriers to entry have been reduced, allowing firms that had specialized in one service to expand more easily into other financial services. (Exhibit 1.5)
2. **Impact of Consolidation on Competition** - provided more convenience. Individual customers can rely on the financial conglomerate for convenient access to multiple services.
3. **Global Consolidation of Financial Institutions** - Many financial institutions have expanded internationally to capitalize on their expertise.

Exhibit 1.5 Organizational Structure of a Financial Conglomerate



Credit Risk for Financial Institutions

1. Following the abrupt increase in home prices in the 2004-2006 period, many financial institutions increased their holdings of mortgages and mortgage-backed securities.
2. In 2007-2008 period, mortgage defaults increased and home values declined substantially.

Systemic Risk during the Credit Crisis

1. **Systemic Risk** is the spread of financial problems, among financial institutions and across financial markets, that could cause a collapse in the financial system.

2. Mortgage defaults affected financial firms in several ways:
   a. Mortgage originators sold mortgages to other financial institutions shortly before the crisis.
   b. Many other financial institutions invested in derivatives and were exposed to the crisis.
   c. Some financial institutions relied on short-term funding and used MBS as collateral.
   d. Decline in home building activity caused a decrease in the demand for many related businesses leading to a weak economy.

Government Response to the Credit Crisis

1. Emergency Economic Stabilization Act

   Intended to resolve the liquidity problems of financial institutions and to restore the confidence of the investors who invest in them.

2. Federal Reserve Actions - Fed provided emergency loans to many securities firms that were not subject to its regulation.

3. Financial Reform Act of 2010
   a. Also referred to as Wall Street Reform Act or Consumer Protection Act
   b. Mortgage lenders must verify the income, job status, and credit history of mortgage applicants before approving mortgage applications.

SUMMARY

- Financial markets facilitate the transfer of funds from surplus units to deficit units. Because funding needs vary among deficit units, various financial markets have been established. The primary market allows for the issuance of new securities, and the secondary market allows for the sale of existing securities.
- Securities can be classified as money market (shortterm) securities or capital market (long-term) securities. Common capital market securities include bonds, mortgages, mortgage-backed securities, and stocks. The valuation of a security represents the present value of future cash flows that it is expected to generate. New information that indicates a change in expected cash flows or degree of uncertainty affects prices of securities in financial markets.

SUMMARY (Cont.)

- Depository and nondepository institutions help to finance the needs of deficit units. The main depository institutions are commercial banks, savings institutions, and credit unions. The main nondepository institutions are finance companies, mutual funds, pension funds, and insurance companies. Many financial institutions have been consolidated (due to mergers) into financial conglomerates, where they serve as subsidiaries of the conglomerate while conducting their specialized services. Thus, some financial conglomerates are able to provide all types of financial services. Consolidation allows for economies of scale and scope, which can enhance cash flows and increase the financial institution’s value. In addition, consolidation can diversify the institution’s services and increase its value through the reduction in risk.

SUMMARY (Cont.)

- The credit crisis in 2008 and 2009 had a profound effect on financial institutions. Those institutions that were heavily involved in originating or investing in mortgages suffered major losses. Many investors were concerned that the institutions might fail and therefore avoided them, which disrupted the ability of financial institutions to facilitate the flow of funds. The credit crisis led to concerns about systemic risk, as financial problems spread among financial institutions that were heavily exposed to mortgages.